RECENT TENDENCIES IN CORPORATION FINANCE[1]

American industrial corporations passed through two financial crises in the past six years. Perhaps one ought to say they have passed through one crisis and are now passing through the second. From 1916 to 1920 the upward swing of one of the most pronounced business cycles this country has ever known brought serious problems to our corporations—problems of financing an expanding volume of business at an increasing price level, complicated by war taxes. From the middle of 1920 on, equally serious difficulties have been confronted in the down swing of the cycle—problems of writing down and working off high cost inventories, meeting fixed charges in addition to operating deficits, paying off bank loans, dodging receiverships.

It is to be noted that the railroad and public utility corporations have experienced a cycle the reverse of the above. With fixed rates, rising tardily and against strenuous public resistance, 1916 to 1920 were lean years. Since 1920 the financial pressure has eased and many of them are "in clover." For these a period of extensions and betterments is at hand.

How have our industrial and public utility corporations weathered these two storms? What types of securities have they used when appealing to the public for capital? Have they in these sobering moments occasion to regret some of the covenants so freely entered into during the intoxicating years of prosperity? Have the investment bankers seized the opportunity to strengthen their control over our industrial machine? These and many other interesting questions are raised by the financial events of the past six years.

In order to throw some light on these problems an examination was made of the changes in capitalization, occurring between 1916 and 1921, of 211 industrial corporations and 72 public utilities. About half of the concerns studied are well known, with their securities listed on the leading exchanges. The other half are small but none-the-less representative corporations.

INDUSTRIAL CORPORATIONS

The 211 industrials made a total of 405 issues of securities during the five years, of which 269 were stock and 136 were bonds and short-term notes. This means that in two-thirds of the cases the appeal was made to the "ownership element" while in one-third of the cases creditors were interested. Since these proportions were reversed in the case of the public utilities (two-thirds bonds, one-third stock) these facts afford some evidence that the industrials are observing the old principle that companies with fluctuating earnings should "go easy" on bonds. However, as pointed out below, one of the most significant tendencies is to make of preferred stock a security which will straddle these two interests and catch the very large group of buyers who do not care to be "speculative" stockholders nor "conservative" bondholders.

Of these 269 issues of stock, 136 were of common and 133 were of preferred. Easily the most striking feature of the common stock issues was the pronounced trend toward no-par stock. Almost half (62 of the 136 issues) were "common of no-par value."[1]

Considering that New York authorized this type of security as recently as 1912, that practically all other states permitting its use have done so since that year, and that to date less than half the states have legalized stock without par value, its growth in popularity has been phenomenal. What is to be said for and against it?

ADVANTAGES OF NO-PAR STOCK

Advocates of this type of security are willing to have it tested from three points of view—that of the corporate finance manager, the creditor, and the stockholder. Since the kind of securities employed has practically no relation to either the labor or the price policies of the company, it is evident that the three classes mentioned include all the groups vitally concerned.

First, as to the corporate financier. No-par stock is flexible and elastic. The original issue can be put out at any price per share that the directors deem expedient. Successive issues can be sold above or below this original price. No question is raised regarding the stock being full paid, so long as the price is made in good faith and

[1] Among some of the more prominent companies using no-par common are American Chicle, Cuba Cane Sugar, Columbia Graphophone, Chandler Motor, Famous Players–Lasky, Goodyear Tire and Rubber, General Motors, Goodrich Rubber, General American Tank Car, International Cement, Montgomery Ward, Maxwell-Chalmers, Pierce Arrow Motor, Stewart Warner Speedometer, Stutz Motor, Wilson and Co., and Western Electric.

that price is actually received in cash, property, or services. The subterfuges used to get around the legal prohibition against issuing stock for less than its par value are abolished. No longer need promoters turn in to the new corporation property and services at twice their actual value in order to receive a large amount (in par value) of stock, then donate back half of it to become treasury stock, after which it can be "legally" sold at a discount or given away as bonus stock. This has been repeatedly practiced when it was impossible to market stock at par. If no-par encourages straightforward dealing in the formation or expansion of corporations it shall assuredly score one on that issue.

Second, as to the creditor. It has been claimed that par value reveals at a glance the amount that the stockholders have invested, hence tells creditors how much equity there is back of their loan. To this there are two replies: The par value never represents, either at the start or subsequently, the real equity of the stockholders, and furthermore credit is never extended nowadays, if indeed it ever was, on the basis of what the stockholders originally invested. The shrewd creditor looks not at the proprietorship items, but at the assets, at the important ratios, at the earning power, at the personnel of management, and at the business outlook. Hence it is evident creditors are no worse off with no-par than with par value and indeed may gain if no-par tends to promote more honest accounting.

Third, as to the stockholder. So long as a considerable class of security buyers persist in believing that there is some mysterious law that will eventually pull the market value up to the par value, society must welcome anything that will help shatter such a belief. No-par stock puts the prospective investor on his guard. "What is it worth?" leads him to not inquire as to par value and buy if the price is below par, but to inquire as to the actual worth. And he may ask: "What is a share of stock anyway?" And the answer should come: "Simply a fractional part of the ownership, your proportion of the equity remaining after prior claims to income and capital are satisfied." This should lead him to inquire as to the prior claims, the income, and the capital assets. If he gets that far the victory for sober investing will be won. The advocates of no-par stock do not regard it as a cure-all. "Suckers" will still be born every minute and Blue Sky laws will still be needed; but if it does nothing more than dispel the notion that the par value and the actual value are or ever will be the same, it will have justified its existence.

DISADVANTAGES OF NO-PAR

First, because it is an innovation, people do not understand it, business customs are set against it. Obviously this in itself will not stay the onward march of this youthful security.

Second, much of our state taxation is based on par value. One might argue over the proposition whether par value *ought* to be the basis of any tax but remembering that taxes have a hard time finding any basis we may pass that by. Suffice it to say, New York, Illinois, and many other states legalizing no-par stock have not let the no-par corporations escape their burdens.

Third, the law measures the liability of the stockholders of some corporations, such as banks, by the par value. For these corporations one might either take the position that they should continue to use par value since very few or no abuses surround their stock issues, or that no-par could be used coupled with the proviso that in case of failure the holder is liable for an amount equal to what was originally paid in for the stock.

Fourth, the law generally holds stockholders of any corporation liable for the difference between the par value and the amount of value turned in for the stock. If the stock has found its way into the hands of innocent purchasers the law holds the original buyer. Hence it is claimed par value gives creditors a measure of the liability of stockholders where inflated assets are traded for stock and the concern later goes bankrupt. This protection is more apparent than real. In the first place it is difficult to establish the "fair" value of property and services turned in to a corporation; the courts are reluctant to overrule the judgment of the board of directors in such matters. Realizing this, creditors seldom try such litigation. In the second place, whatever protection there is in such a law can be carried over into no-par stock. Why not say that original owners of no-par shares are liable for the difference between the price set on the shares and the value of the property and services they gave in exchange?

Fifth, the balance sheets of corporations using no-par stock are unstandardized. Some companies, such as General Motors, carry the stock at its original issue price and then have a surplus account. Others, such as Famous-Players, carry the stock at present market value with a surplus account. A third group carry their stock at a nominal figure, e.g., Pierce-Arrow at $5 per share, and show a surplus. A fourth method, used for example by General American

Tank Car, is to divide the equity of the common stockholders by the number of shares and thus get a book value per share and show no surplus. Although this objection does not strike at the merits of no-par stock, nevertheless it would be well to standardize these reports. Of the four methods in common use that of reporting the stock at market value is the least defensible, since the figure given on the balance sheet is obsolete by the time the report is published and if one is really interested he can ascertain the market price without looking up the corporation report. Two of the other methods are valuable to certain parties; to know the original investment and how much of the profits made have been reinvested in the business (surplus) is important information to some people, as is the present book value of the stock. There is no reason why both should not be reported on the balance sheet.

On the whole the champions of no-par stock seem to have the better of the argument and we may confidently expect its wide extension. In fact the no-par arrangement is even creeping into preferred stock. The Lucey Manufacturing Company issued in 1920 a Class A no-par stock which is cumulative in dividends at $5 per year per share until 1923 and thereafter is cumulative at $8 per share per year, and a Class B no-par common. The Disco Milling Company has issued a preferred whose dividends are cumulative at $1 per share per year; the Shotwell Manufacturing Company issued in 1920 a Class A stock carrying 80 cents per year per share dividend ranking ahead of the Class B no-par stock; Montgomery Ward and Company in 1919 issued a Class A stock of no-par value, with cumulative dividends of $7 per share per year, followed by no-par common.

The foregoing cases point also to another recent tendency, namely, to break away from the old simple classification of stocks into preferred and common, and create other varieties of stocks. In England "founders" shares, coming after the common or "ordinary" shares, have been in vogue for a long time. Here we find the Armour Leather Company, formed in 1919, issuing preferred, common, and founders shares. General Motors is using cumulative preferred, cumulative debenture stock, and no-par common. Goodyear's recapitalization in 1921 brought out prior preferred, preferred, management stock (loaded with voting power to give the reorganization committee control) and no-par common. American Chain Company has a

7 per cent preferred, a Class A 7 per cent cumulative but receiving up to 10 per cent if earned, a Class B 7 per cent cumulative receiving up to 10 per cent if earned, and no-par common. Armour and Company recently changed their capitalization to a 7 per cent preferred followed by Class A receiving 8 per cent, then Class B receiving a like percentage, then A and B share equally. Channell Chemical Company changed their capitalization in 1920 to provide for a Class A stock, no-par $6 per share per year cumulative dividend, and Class B no-par, with $6 per share per year cumulative dividend, after which both participate equally.

While most of these stocks differ more in name than in fact from the old-fashioned preferred and common, yet they are certain to bewilder investors and may be the beginning of a practice which will finally give us as great an assortment of stocks as we now have of bonds. Should that unhappy day arrive the financial page of the newspaper will contain references to and quotations on as many varieties as the famous Pittsburgh pickle firm boasts.

PREFERRED STOCK

One of the most interesting recent tendencies is for corporations to develop a flexible capital instrument in the form of preferred stock. As stated above 133 issues of this type were brought out by the 211 industrials as compared with 136 issues of common. Considering that some of these companies were started during this period and hence had to issue common, the fact that the number of preferred issues practically equaled that of common proves that the preferred stock was adapted to the occasion. In fact there were two major forces at work to popularize this instrument. The first was that corporate financiers had to raise capital in large and increasing amounts throughout this period and desired if possible to do this without sharing control or creating fixed charges; the second force was the excess profits tax of the federal government.

To consider the second proposition first. This tax, passed in 1918, levied progressive rates on profits made in excess of 8 per cent on invested capital. At once the troublesome query arose: "What is invested capital?" Among the rulings forthcoming from the Treasury Department on this moot question was one which held that capital derived from the sale of stock was "invested" capital while that obtained from the sale of bonds or notes was not invested. Instantly the corporations seized upon the straight, old, 6 per cent cumulative

preferred and dressed it up in all sorts of strange costumes. Patriotic urgings to pay taxes willingly fell on deaf ears as clever financiers stripped the covenants off of bonds to clothe their new creations. Aside from the fact that these preferred stocks rank after the loans, it would take more than an "expert" to find any essential differences between some of these war-evolved preferred stocks and bonds.

The other force at work causing the recent widespread use of preferred stock was more economic in nature. As the war prosperity, beginning in 1915, accumulated and intensified more capital was imperatively demanded. Plants had to be enlarged, payrolls went up, materials steadily advanced; the longer the war continued the more pressure there was to transfer this burden from the commercial banks to the investment market, corporate managers—representing, theoretically at least, the common stockholders—did not want to undertake the burden of fixed charges in post-war years. They were afraid a collapse of demand would sink their "net" below the zero point. Hence they were strongly inclined to use stock rather than bonds. Fortunately for them the war boom, which created the need for more capital, created the profits which made their outstanding stocks sell at attractive figures. The market was in a receptive mood for stocks. But why not use common stock? Common stock was in fact extensively employed; in many cases, however, the common stockholders did not want to share their advantageous position with others. They desired more capital but did not want it represented by bonds, neither did they want more common shares. The non-voting, cumulative, sinking fund preferred met the need.

How extensively stocks predominated over bonds during the boom period is shown in the following table:

KINDS OF SECURITIES USED, BY YEARS

	1916	1917	1918	1919	1920	1921 (Till May)
Common stock	27	21	8	30	41	3
Preferred stock	18	22	8	31	21	5
Bonds	14	13	2	14	15	13
Notes	4	4	7	10	27	5

It will be remembered that little public financing was permitted by the government in 1918. The table shows how extensively stocks were used until the bubble burst in May, 1920. After the period

of liquidation began, profits shrank and stocks were useless as a capital-raising device. Then it was the short-term note became popular and by 1921 bonds were overwhelmingly predominant.

Voting power.—In devising the special features of these recent preferred stock creations it should be recalled that corporate managers did not want to share control with the capital furnishers. To deny a share in control means depriving the security of voting rights. Such is the pronounced tendency in these recent preferred stocks. Examination of 157 preferred stocks disclosed only 20 per cent with full voting power; 25 per cent gave no voting power under any circumstances while the remaining 55 per cent conferred conditional voting power on the holder.[1]

The special conditions which confer voting power on the preferred stockholder are various. The one most frequently found is that when preferred dividends are in arrears for a certain period (usually four quarters) then the preferred shall have voting power. In some cases more teeth are put into the voting power by providing that if dividends are passed for a certain period then the preferred shall have exclusive voting power, thus turning control of the management over to the preferred. An increasing number of companies are saying to their preferred stockholders: "If we do not maintain quick assets at a 2 to 1 ratio to current liabilities," or more commonly, "If we do not maintain net quick assets (working capital) equal to 150 per cent of outstanding preferred stock then we will allow you to vote for directors."

Thus it is evident that the modern tendency is to ask preferred stockholders to keep hands off so long as their principal is safeguarded and their dividends are regularly forthcoming; but whenever things break badly and either principal or income is threatened then to invite the preferred either to participate in management or take it over altogether.

Callable features.—Of the 157 preferred stocks examined 90 per cent are callable. The call price varies from par to 125 but almost half the entire number made the call price 110, so that may be taken as typical. But giving the corporation the right to buy back its stock and actually buying it back are very different things. To what extent are these companies actually retiring their preferred stocks? A surprisingly large proportion impose sinking fund requirements on

[1] Recently the Supreme Court of Illinois ruled that under the constitution of the state no corporation chartered in Illinois can deprive any stockholder of voting power.

themselves and use the fund to retire the preferred stock. No less than 82 per cent of the companies having callable provisions obligate themselves for sinking funds.

There are two fundamental principles on which these sinking funds are based, with a great many varieties of detail from each of the main bases:

A. A specific, flat amount to be set aside each year and applied to the retirement of the preferred. This flat amount is sometimes stated in dollars, as $110,000 per year; more frequently as a percentage of the maximum amount issued, as 3 per cent of the maximum issue to be retired annually. Among the 157 cases over half of the companies with sinking funds used this flat amount method. It is the less desirable of the two from the standpoint of good, corporate, financial management. It ties the corporation to a special equal burden each year, regardless of business conditions. Whether the firm is making money or not, it has covenanted to set aside and use so much income to retire preferred stock. In years of business depression it is certain that many firms will not be able to live up to this requirement.

B. A percentage of the net earnings each year. This basis, being elastic, is much better for the company and in the long run for the preferred stockholder as well. In lean years it is better to forego retirement of part of their stock than to add to the troubles of a financially embarrassed management. When a corporation is finding it well-nigh impossible to meet operating expenses and fixed charges, it goes without saying that it cannot be forced to buy in some of its own preferred stock.

If careful financial management dictated the sinking fund provisions it is difficult to see how the first of these two methods should ever find a place.

Covenants and penalties.—Another tendency strongly evident in recent issues of preferred stock is for the corporation to make various covenants which, ostensibly at least, protect the stockholders' principal, and to place in the hands of a trustee an indenture containing these covenants and the penalties attaching for their violation. These covenants are of three general kinds:

A. Regarding sinking funds. These have been considered above. In general no penalties attach to their violation. Occasionally a company gives preferred stock voting power or says no dividend shall be paid on common if such a covenant is broken.

B. Regarding maintenance of assets. To safeguard the investment it is common to find covenants to maintain *net quick* assets at from 100 to 150 per cent of the outstanding preferred and *net tangible* assets at from 200 to 300 per cent of outstanding preferred. Here again the majority of concerns are long on promises and short on penalties. However, one finds more penalties than in A above. When punishment is provided it takes the form of stopping dividends on common or giving voting rights to preferred. Whether these covenants will be violated or not would seem to depend on the honesty of the accounting policy of the corporation. It would be comparatively easy to have the books show such ratios at the time statements are published, even though the company did not actually have the necessary assets.

C. Regarding issues of additional securities. These are of two sorts: mortgage bonds and additional preferred stock. As to mortgage bonds 111 out of the 157 covenant not to place any future mortgage (except purchase money mortgages) on any of the fixed assets of the company without the consent of a large percentage (usually 75 per cent) of the preferred stock. Since these covenants closed the door to mortgage bonds we have witnessed a great many issues of short-term notes and debenture bonds. As to additional preferred stock being issued, such is usually allowed if two-thirds or three-fourths of that already outstanding votes favorably and if the net quick assets and net earnings are ample to safely permit taking on additional shareholders. These covenants are practically self-enforcing. If the three-fourths vote is not obtained the mortgage bonds cannot be issued. (But the funds can be obtained by issuing debenture bonds or short-term notes which of course rank ahead of the claims of the preferred stockholders.) If the net quick assets are not up to covenant, which is usually that such assets must be kept at 200 per cent of the total preferred including the proposed new issue, then the new issue cannot be brought out. Likewise the covenant regarding net earnings is self-enforcing. If the net earnings are not equal to at least three times the dividend requirements on the total preferred issued and to be issued, then the proposed issue is tabled.

Reflecting on these various provisions in recent preferred stocks one cannot help feeling that such a security more nearly resembles a bond than it does a stock. The dividends are cumulative—so is bond interest. The holder under ordinary circumstances gets no vote for directors—neither do bondholders. The holder, however,

gets a voice in management or assumes it altogether if his dividends are in arrears—so does the bondholder through foreclosure. The preferred stock is callable with a sinking fund to redeem it—so with bonds. Protective covenants safeguard the principal of the preferred stockholder—so it is with recent bonds and short-term notes. Indeed about the only similarity between common stock and these new-fashioned preferreds is that the law regards them both as evidences of ownership, not creditorship. Legally, preferred and common stock resemble each other; in practically every other way they are different. It would appear that in this instrument corporation finance had struck an unusually flexible and facile device to tempt that large strata of capital suppliers who want neither a pure speculation nor the conservative 5 or 6 per cent mortgage bond. Surely also, corporate management must realize that there is no small advantage to itself in being relieved of the fear of receivership in case default on dividends occurs. Receiverships are notoriously expensive. The general public will gain if they are reduced to a minimum. Undoubtedly the recently devised preferred stock will contribute to that end.

Let no one be deceived, however, into thinking that any type of security is a substitute for cautious discrimination on the part of the investor, nor for sound business policy on the part of corporate management. These must be relied on always to be the truly effective means toward a sounder financial basis for our corporations.

SHORT-TERM NOTES AND BONDS

During the recent boom period, as we have seen, stocks were the favorite instrument of capital raising. As soon as the index number of commodity prices turned downward, the corporations had to turn to borrowing. The reasons are apparent. When prices stopped rising and then began to fall orders were canceled, profits turned into losses, high-cost inventories piled up and simultaneously stocks tumbled. Indeed the "key" stocks broke as early as November, 1919, discounting the decline which occurred six months later. With stocks on the toboggan it was useless to think of trying to market new issues of any kind of stocks. Not even the most elaborate covenants in preferred could make them palatable. Yet the industrials were in imperative need of funds. The banks had been furnishing them large amounts of working capital. Now the banks began pressing the corporations to fund their indebtedness into securities

and pay off or reduce materially their bank loans. Throughout the latter half of 1920 short-term notes, mostly of five or ten years maturity, appeared in great numbers. The circulars describing these notes stated with monotonous frequency: "Purpose, To pay off current indebtedness and provide additional working capital."

Many of these notes were made convertible, the advertisements playing up the high prices of the company's stock during the preceding five years as a reason why the conversion privilege should be highly regarded. Doubtless many investors accepted this dubious argument. Another interesting feature of these recent short-term notes is the surprisingly large proportion (43 per cent) that mature serially. To the corporation there are two noteworthy disadvantages in this type of security. First, it involves a different market price for each maturity of the series, thus rendering it less marketable; and second, in years of depression it imposes the same definite obligation to redeem part of the notes as is imposed in years of prosperity. Already this second disadvantage is of more than academic importance to some companies.

Finally by the end of 1920 the market became surfeited with notes, even 8 per cent interest not being sufficiently attractive to market them in the face of the apathy of investors. Then it was that the industrials were driven to bonds. It was an unfortunate time to have to use this instrument. Market rates of interest were high, hovering around 8 per cent for industrial bonds. This would mean that by the time underwriting commissions were paid money would cost the corporation from 9 to 12 per cent or even more. There was every prospect that by late in 1921 interest rates would be lower and would continue to fall after that. It would have been a propitious time to use the short-term note as a borrowing instrument. But the short-term note had worn out its welcome. Under these circumstances the corporations had to make the best of things, issue their bonds at expensive rates and extract what comfort they could from the fact that they made these bonds callable. If the interest rates for this type of security fall to $5\frac{1}{2}$ or 6 per cent, which is another way of saying that if the market price of these bonds rises considerably above par, it will be profitable for the issuing companies to pay another underwriting commission and have the old, high-rate bonds called in and paid off with the proceeds of the sale of new, lower-rate securities. Indeed it is possible that within the next five years stocks may recover a considerable part of their recent losses in which case capital

funds might be secured cheaply from the sale of preferred or common stock and these 7 and 8 per cent bonds retired with the proceeds. If such a situation should come about it would mean that the corporations that used the convertible bond might find themselves rid of their debt without going through the investment banking channels at all.

A final observation on these industrial notes and bonds. The government educated a vast number of people to the bond-buying habit during the Liberty Bond campaigns. It is estimated that there were only a half-million bondholders in this country prior to the war, whereas in 1919 they were said to number twenty millions. The vast majority of these could not hope to buy corporate bonds of a denomination even as high as $500. So the tendency has been to try to catch these small bond-buyers by offering the "baby" bond of $100 denomination and combining with it the instalment plan of purchase. Whether this will pay the investment houses remains to be seen. It costs practically as much to sell and handle a $100 bond as it does a $1,000 bond even if bought outright, while with the instalment payment plan it probably costs considerably more. However, if enough of these small purchases grow into $500 and $1,000 accounts, the bond houses will be repaid. Probably also, the tendency to reduce the par value of stock to $25 and $10 goes back to marketing considerations.

PUBLIC UTILITIES

As stated above 72 public utilities were studied to see wherein their financing differed from that of industrials. These concerns made 142 issues of securities of which 47 were stocks and 95 were bonds and notes. Why should we find here two-thirds of the issues bonds and notes whereas the industrials used stocks in two-thirds of all their cases?

It is safer for public utilities to borrow than for industrials because, first, the demand for their product is stabler than for that of most industrials; second, they are protected against competition; third, their rates in the larger communities are fixed by public authority and insure a reasonable return on the "fair" value of the property employed; fourth, they have a heavy investment in fixed assets to offer as mortgage security for bonds. It is not surprising therefore that they should so successfully appeal to the bond-buying classes.

Another significant difference between the public utility and industrial issues is that 30 per cent of the public utility bond issues were for refunding purposes, while practically none of the industrials were so. It is clear that the public utilities are coming to regard their debts as perpetual. When one bond issue matures another takes its place. In this respect these concerns are following the example of the railroads.

Another difference is the fact that public utilities seldom give as the purpose of the security issue, the raising of working capital. Less than 7 per cent of the issues mentioned working capital as a purpose. Are the public utilities ashamed to admit they go to the investor for working capital or are they not in need of the working capital that industrials must have? The truth seems to be that they need relatively small amounts of working capital and that the public furnishes what they do need in other ways than through interest-bearing securities. They need less because the typical electric light, or gas, or telephone, or street railway company has few accounts and notes receivable and those of short-time duration, mostly 10 to 30 days; furthermore they collect in advance for many of their services, such as street-car rides, thus being furnished with their working funds by the consumer; they carry relatively small inventories for they sell services rather than commodities. Hence the maintenance of adequate working capital is no problem for them.

It is common observation that the holding company movement is proceeding rapidly among the public utilities. Evidences of this are apparent in their financing. For example, where the purpose of the issue could be determined it was found that 54 per cent of the bond issues were for expansion. "Expansion" does not necessarily prove the growth of holding companies but it probably points to that in a large proportion of the cases. Further evidence of the holding company movement is seen in the large number of issues secured by collateral; 30 of the 95 bond issues were so secured. In most cases this collateral means stocks and bonds of subsidiaries, put up by the parent as security for its own bonds.

There are certain economic advantages in this holding company movement. In the first place the parent company needing large blocks of capital at one time can raise the funds more cheaply than the small separate concerns could. Second, these securities are better for the investor both because they are more marketable and because his funds find their way into the productive property of subsidiaries

in different communities thus spreading his risk. Third, the holding company benefits by virtue of the fact that it draws its income from the income of its scattered subsidiaries; such subsidiaries are likely to produce a fairly uniform and steady income for the parent since lessened demand in one community is likely to be offset by improving conditions in another. Fourth, economies in management especially in purchasing and reduction of overhead can be effected by the holding company. Fifth, the holding company can plead its cause before public utility commissions more effectively than small separate companies. Sixth, large holding companies alone can make a reality of the potential marvels of hydroelectric development.

So far as stocks are concerned the public utilities seem to be sticking close to the old-fashioned preferred and common. There is scarcely any tendency to adopt no-par stock, neither are they creating variations from preferred and common. Middle West Utilities is one of the exceptions, having provided in 1921 for no-par common and a prior-lien stock ranking ahead of preferred. Cities Service Company has had for several years "Bankers' shares," each share representing one-tenth equity in a share of their high-priced common.

CREDITORS' CONTROL

When a corporation found itself insolvent under the old system of things the officers moved for a receiver and at frightful cost the affairs were reorganized, after which the bankers, representing the creditors, insured themselves control for the ensuing critical years by tying up the common stock in a voting trust. The management was under the control of the financiers, who were acting for the protection of their clients, the security buyers.

The recent tendency is to avoid these expensive receiverships and organize a "rescue party" composed of the interested banking houses. This rescue party moves in when "technical" insolvency is reached, proceeds to do a thorough job of financial reorganization, looking carefully after the interests of the various classes of creditors and, if rumor has it right, taking pretty generous commissions for their own services. They then proceed to sew up control of the affairs of the company in their own hands during the life of the new bonds. Instead of using the old voting trust arrangement, the tendency now is either to issue to themselves a special kind of voting stock or have an ironclad agreement with the stockholders that the management selected by the financiers shall be kept in power. It is not usually

difficult to get the stockholders' consent to relinquish their voting power. The bankers simply tell them that the alternative is receivership. To this powerful argument is added the practical help that only a few of the larger stockholders take an active interest anyway, and since these few are usually involved in the management their co-operation is assured.

The friendly reorganization of the Goodyear Tire and Rubber Company in 1921 resulted in the creation of $10,000 management stock, heavily loaded with voting power and held by the reorganizing bankers, who immediately ousted President Sieberling and put in a new management. The circulars announcing the $10,000,000 First Mortgage twenty-year bonds of the Fisk Rubber Company stated:

> During the life of these bonds control of the management of the Company through the right to elect two-thirds of the Board of Directors, will be vested in Messrs. James Dean, of Dillon, Read and Company, Otis H. Cutler, Chairman of the Board of American Brake Shoe and Foundry Company, and H. T. Dunn, President of the Fisk Rubber Company, or their successors, through the issue of Management Stock.

The Cuba Cane Sugar and Moline Plow companies came through their friendly reorganizations with the financial powers in control.

What does it mean? Are we in for an era in which the policies of industries are to be finally passed or vetoed by the financiers? Can the "protection of investors" justify such vigorous measures as "firing" the old management and naming the new? Has it come to this, that however medieval a corporation's *labor* policy may be nothing will happen, unless perchance the laborers force a change, but if the corporation's *financial* policy gets the company into difficulty the bankers must immediately take charge? Perhaps so. Perhaps the results to the public will justify these measures. The defense of the investment bankers is that their clients must be protected. Capital must be safeguarded. They probably would not deny that labor and the public need safeguarding also, but the simple fact is that capital is organized and on the job while the other interests are not. Such a procedure, we are assured, is better for all concerned than receivership.

But the question may be raised: If the financiers are to supervise management after the corporation's finances have come to the point of insolvency, why should they not supervise them before they reach such a condition and thereby prevent the trouble? If this logical development works out then what becomes of stockholders' control?

Would management by financial houses in the interests of creditors be any worse for the public than management by a small group of common stockholders, who alone take any active interest in the exercise of their voting power? Might it not be better? Or might it not be best of all to have all the parties interested—creditors, stockholders, laborers, and the public—share the management responsibilities? It is a long way to that goal, perhaps, but the growing tendency for creditors to get protection by representation in management may be a step in that direction.

SUMMARY

Two-thirds of the public utility financing is done by borrowing while two-thirds of the financing of industrials is done by sale of stocks.

During the boom period preferred stock was the favorite instrument; immediately after the break of prices in 1920 short-term notes predominated, while the depression of 1921 has been prolific of bond issues.

There is a pronounced trend toward no-par stock among industrials; little evidence of it as yet among the public utilities.

The industrials are tending to create varieties of stocks, other than preferred and common.

Recent preferred stocks are being made callable, are carrying attractive covenants regarding maintenance of large working capital, net tangible assets, and sinking funds for retirement of such stock; many of which covenants are certain to be violated and no penalty suffered.

Public utility companies are coming to regard their debts as perpetual, whereas industrials nearly always provide sinking funds or use the serial type of bond.

The holding company movement is gathering speed among the public utilities and offers promising advantages to the public, provided of course that regulation is effective.

The $100 denomination of bonds and short-term notes is becoming common.

The friendly "rescue party" is supplanting receivership as a method of reorganizing insolvent concerns and is increasing the tendency for bankers to either participate in or actually control the management of our industries.

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